PHILIP MORRIS COMPANIES INC. ANNUAL REPORT 1987

2025865286

REVIEW OF THE YEAR

TOBACCO

Philip Morris U.S.A.'s unit sales, market share, and income from operations once again rose to record levels in 1987.

Our cigarette unit sales rose 0.5% to 215.6 billion units in 1987, despite a 2.1% industry decline to 570.4 billion units. Operating revenues rose 7.4% to $7.6 billion, while income from operations rose 13.4% to $2.7 billion.

Our full-price brands continue to increase market share despite the growth of price-value products. Philip Morris now holds 40% of the full-price category, in which we generate 96% of our unit sales.

Continuing its momentum, Marlboro remains America's largest-selling cigarette, with 1987 sales reaching 134.6 billion units, up 0.3% over 1986. Further increases in the brand will be aided by Marlboro Lights, which is growing rapidly. Moreover, Marlboro increased its strength in most demographic categories of smokers.

Virginia Slims widened its lead among cigarettes made especially for women with the successful introduction of Virginia Slims Ultra Lights, an ultra low tar line extension in a newly designed five-sided pack. Benson & Hedges successfully introduced Benson & Hedges Lights 100s in a box. The Merit brand continued to benefit from the strong performance of Merit Ultra Lights in the growing ultra low tar category.

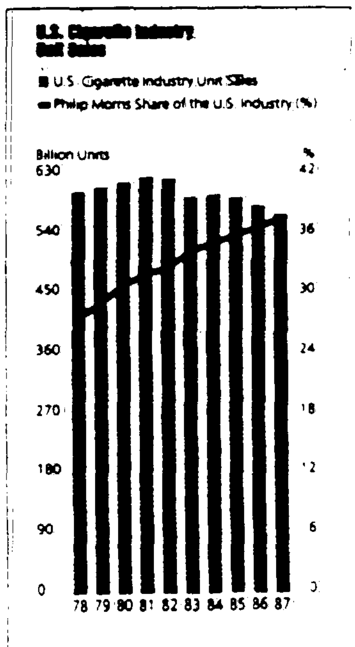
The price-value category, which consists of generic and lower-priced name brands, continued to grow and now accounts for 10% of industry volume. In 1987, Philip Morris U.S.A. introduced full-flavor Cambridge as a quality alternative for price-conscious smokers. The strong performance of the Cambridge brand family led to an increase in the company's share of the price-value category to 15.6%.

Our presence at retail continued to improve as Philip Morris U.S.A. realigned its field sales force to merchandise and promote our products more effectively. In 1987, we increased our share both of retail inventory and of carton and pack display space for all our brands.

American-grown leaf tobacco continues to be the cornerstone of our cigarette blends' superior taste and quality. The Tobacco Program Improvement Act of 1986 has proven effective in enhancing domestic producers' ability to grow quality leaf at competitive prices for the global market.

One part of the program that is proceeding ahead of schedule is the buy-out, by Philip Morris and other major U.S. cigarette manufacturers, of surplus tobacco accumulated from 1976 to 1984 in the growers' cooperatives. The manufacturers have already committed to purchase approximately 60% of these surplus stocks.

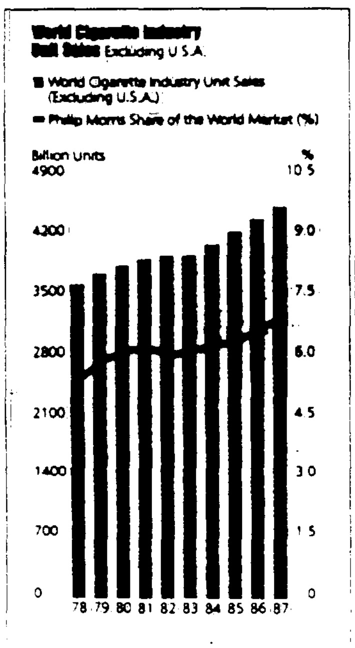
Because of increased demand, the U.S. Department of Agriculture has announced an increase in both the flue-cured and burley quotas for 1988. Together, the buy-out, the quota increases, and Philip Morris U.S.A.'s public commitment to purchase more U.S. tobacco as a replacement for imports have provided growers with positive incentives for future production of flue-cured and burley tobacco.



market. We gained market share in Italy and France, and expanded our share of the large German market to 25.4%. In Spain, due primarily to Marlboro's strong performance, we increased volume and improved our share-of-market by 2.7 share points.

Volume was up for our EFTA, Eastern Europe, Middle East, and Africa (EEMA) region. In addition to the very good performance in Turkey, where volume rose 39%, volume also increased in Egypt, Senegal, and Finland. In Switzerland, our market share climbed to a new high of 38%.

Our exports to Eastern Europe were up 30% and our licensees in Poland, Czechoslovakia, East Germany, and Yugoslavia recorded volume gains. In the Middle East Gulf area, where overall industry volume declined,



we continued to increase our share of the market.

Throughout the Latin American region, Marlboro achieved substantial volume gains, increasing 9.4% over 1986. Our market share improved in every major market where we do business. Performance was especially strong in Mexico and the Dominican Republic. In Brazil, our market share rose even though price increases depressed industry volume.

In Canada, we successfully completed the merger of our subsidiary, Benson & Hedges (Canada) Inc., with Rothmans of Pall Mall Limited to form Rothmans, Benson & Hedges Inc. Although industry volume in Canada was down, profitability of the newly combined operations, in which we have a 40% holding, exceeded expectations.

Our Australian cigarette business performed strongly. Volume rose 3% and share improved by 0.8 share points, led by Peter Jackson, which gained 5.6% in volume.

With the suspension of import duties in Japan and improved access to the cigarette market in Taiwan, volume in the Asian region increased dramatically during 1987. Volume more than doubled in Japan on strong sales by Lark, Philip Morris Lights, Philip Morris Superlights, and Parliament. Marlboro Lights, produced under license by Japan Tobacco Inc., was introduced in Japan in the fourth quarter. In the growing import segment of this large and important market, our brands hold a 62.8% share.

Following the opening of the Taiwanese market to foreign brands in March, Marlboro, Marlboro Lights, and Parliament achieved an 8.4% share. Volume in the People's Republic of China was up 43.8%. In Hong Kong, Marlboro widened its lead as the best-selling brand, increasing volume and market share by 16.1% and 2.7%, respectively. Marlboro's volume and market share rebounded strongly, recapturing its position as the market leader in Singapore.

The year 1987 was another period of investment for Philip Morris International Inc. Our strong volume performance, together with currency gains, enabled us to further increase our marketing spending in a number of important markets. These investments will have a positive impact on our performance in the years ahead.

2025865288

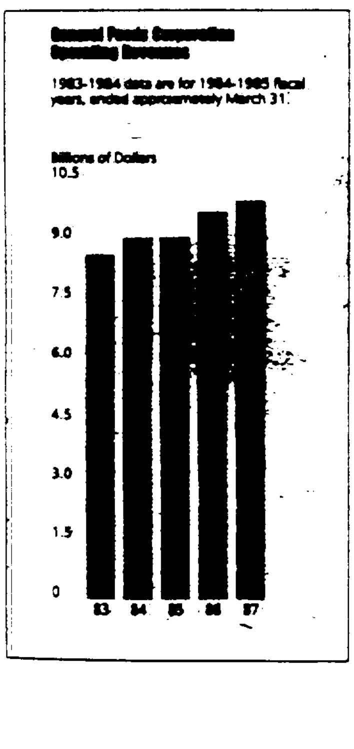
FOOD

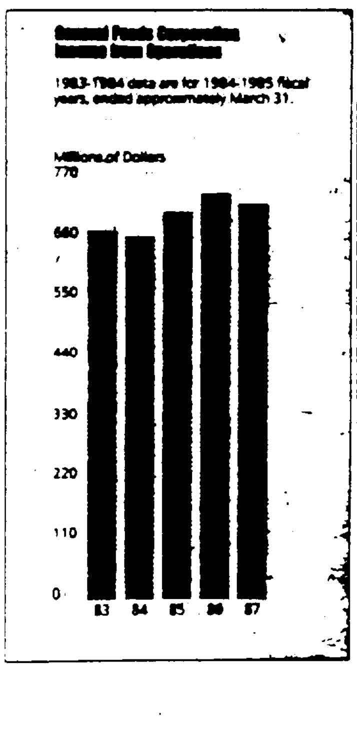
General Foods Corporation's operating revenues increased to $9.9 billion, on 2.9% higher unit volume.

Most of General Foods' businesses performed well during the year, with gains in volumes and earnings. Processed meats, baked goods, cereals, and international products were especially strong in 1987. An exception was domestic coffee, where pricing and marketing spending depressed earnings.

Income from operations in 1987 declined 2.7% to $722 million. The decline reflects a $117 million pre-tax charge for restructuring, which was partially offset by a $46 million pre-tax gain on the sale of the Open Pit barbecue sauce retail business. Excluding these special items, income from operations increased 6.9% to $793 million.

During the year, General Foods Corporation announced a reorganization program designed to improve management effectiveness and productivity. With the formation of three operating companies — General Foods USA, General Foods Worldwide Coffee & International, and Oscar Mayer Foods — a substantial number of staff positions were eliminated and decision-making was moved closer to the marketplace. Certain manufacturing facilities are also being restructured to improve operating efficiencies, and there were savings in other overhead functions.





General Foods USA increased its unit volume by 2.3% in 1987.

Established products performed well, generally increasing their market shares. In cereals, good volume gains helped Post Grape-Nuts, Natural Raisin Bran, Super Golden Crisp, and Pebbles to improve their positions. During the year, we also introduced an innovative cereal packaging — our resealable Zip-Pak.

Jell-O reversed a volume decline and increased its share of the gelatin market to a new high of 77.4%.

Kool-Aid, Crystal Light, and Country Time increased their share of powdered beverages to 78.4%, with strong earnings growth.

Our bakery business performed well, with Entenmann's successfully expanding to the Pacific Northwest. In November, we completed the acquisition of The Charles Freihofer Baking Company, a major regional baker in the Northeast.

We accelerated new product introductions in all menu segments. Crispy Critters, a new low-sugar children's cereal, was marketed nationally. Entenmann's introduced Fruit & Fibre muffins and a line of "indulgence" pastries.

2025865289

Kool-Aid Koolers, in its second year of national distribution, achieved a 13% share and is second in the fast-growing aseptically packaged beverage market.

Jell-O refrigerated ready-to-eat puddings were expanded to full distribution on the West Coast after completing a successful test market.

We gained valuable experience in convenience meals, testing Culinova refrigerated entrees, Impromptu shelf-stable meals, and Ronzoni frozen Italian entrees. Birds Eye introduced two new lines: Custom Cuisine and Deluxe Vegetables.

General Foods Worldwide Coffee & International unit volume was up 3.6% over 1986.

Maxwell House and our other brands continued as the overall share leader in the U.S. market. However, operating income gains in our international operations were more than offset by an earnings decline in our domestic coffee business.

Through 1987, the U.S. coffee market failed to recover from 1986's depressed levels. With overall consumption weak, heightened spending by General Foods was needed to compete, which had an adverse impact on earnings.

Early in the year, we launched a new, naturally decaffeinated Sanka. New packaging and advertising strengthened the position of the Hag brand as Europe's number-one decaffeinated coffee.

We gained share in England with the acquisition of Kenco Coffee Company Limited, a well-established supplier of grocery and food service ground coffee. In Spain, we introduced Saimaza Cafe Superior and widened our lead in the ground coffee market. With broadened distribution, the Gevalia coffee brand increased its share in Scandinavia.

In Canada, our share of coffee in the food-away-from-home market grew with the acquisition of Chase & Sanborn and the Melrose and Dickson food service businesses.

We also increased share in Japan and Korea, and began producing soluble coffee in the People's Republic of China.

All of our non-coffee businesses were strong in 1987. Kibon ice cream in Brazil performed especially well, increasing volume, and earnings despite a difficult economic environment.

In France, our Hollywood gum and Krema confectionery businesses introduced new products and are now distributing Stimerol premium gum in France. We also acquired La Vosgienne, a maker of premium candies.

In January 1988, General Foods' Hostess Food Products, the largest brand of salty snack foods in Canada, announced a plan to form a partnership with Frito-Lay, a unit of PepsiCo, Inc. The partnership is subject to approval of the Canadian government.

Oscar Mayer Foods continued its leadership in sliced luncheon meats, bacon, and hot dogs, and unit volume increased 3.5%.

The market share of Oscar Mayer brand of sliced luncheon meats rose to 26.1%. Our share of the bacon and hot dog categories rose to 10.9% and 13%, respectively.

The unit volume of Louis Rich turkey products was up 10%, as it continues as the leader in its categories.

Oscar Mayer entered test market with several new products. Zappetites is a line of eight snack foods made especially for microwave ovens. The Lunchables line of convenient light meals includes meat, cheese, and crackers.

We are also expanding distribution of surimi-based products from the Louis Kemp Seafood Company, which was acquired in 1986. It produces a line of lower-cost, natural alternatives to crab meat.

2025865290

BEER

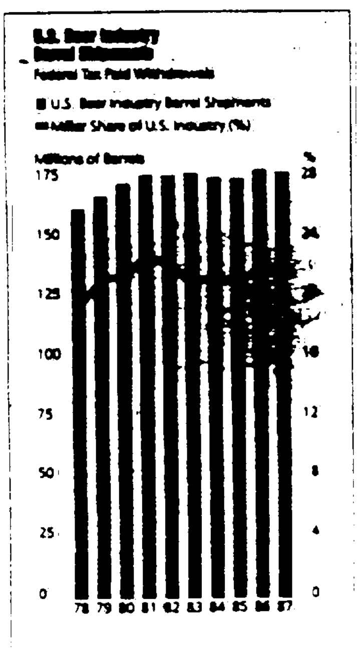
Miller Brewing Company's shipments of 39.3 million barrels were up 1.4%.

Income from operations of $170 million in 1987 was 10% higher than the 1986 level, while operating revenues rose 1.7% to $3.1 billion.

In the premium beer segment, Miller Genuine Draft increased its sales strongly over 1986 to 2.6 million barrels.

Miller Lite, the second-best-selling beer in the United States, continues to lead the low-calorie segment by a substantial margin.

Although Miller High Life's volume declined again in 1987, it



remains the third-best-selling beer in the U.S.

In the popular-priced category, Meister Brau and Milwaukee's Best increased their combined volume. Meister Brau Light was introduced during the year in five Eastern states to meet consumer demand for reduced-calorie, popular-priced beers.

During the year, we introduced Matilda Bay Wine Cooler. This is a premium blend of white wine and fruit flavors and is the first non-carbonated wine cooler on the market.

Financial Services and Real Estate Operations

The financing revenues of Philip Morris Credit Corporation (PMCC) declined 1.1% to $162 million, including intercompany transactions of approximately $4 million. Net earnings also decreased 6.3% to $51 million. Year-to-year financial comparisons are distorted because of 1986 adjustments to PMCC's leveraged leasing portfolio resulting from the effects of the Tax Reform Act of 1986 and certain related leveraged lease renegotiations.

Excluding the impact of this accounting adjustment, PMCC's 1987 financing revenues and net earnings would have increased by 20.9% and 21.1%, respectively, over the prior year. PMCC's growth resulted primarily from the continued expansion of its financial service operations.

In 1987, PMCC invested $349 million in leveraged leases, bringing the value of the equipment portfolio to almost $4 billion. We also continued to support Philip Morris' operating companies by providing financing to their customers.

Mission Viejo Realty Group Inc.'s operating revenues exceeded the prior year by 10%. Its 1987 net earnings of $21 million, including amortization of goodwill, were a record. Although the Colorado real estate market continued to be soft, the California residential housing, land, and business properties markets remained strong.

PMCC was in a good financial position at the end of 1987, with a capital base equaling $579 million. This base provides ample financing capacity to accommodate our growth in 1988 and beyond.

In summary, Philip Morris Companies Inc.'s 1987 results reflected prior years' investments in new product development, in long-term marketing programs, and in modern plant and equipment. We will continue to invest now, for future profitable growth

2025865291

SELECTED FINANCIAL DATA—FIFTEEN-YEAR REVIEW (in millions, except per share amounts and employees):

	1987	1986	1985	1984	1983
Summary of Operations:					
Operating revenues	$27,695	25,409	15,964	13,814	12,976
United States export sales	1,592	1,193	923	925	970
Cost of sales:					
Cost of products sold	11,264	11,039	6,318	5,517	5,343
Federal excise taxes	2,085	2,075	2,049	2,041	1,983
Foreign excise taxes	3,331	2,653	1,766	1,635	1,527
Income from operating companies	4,193	3,707	2,760	2,296	1,944
Interest and other debt expense, net	685	770	308	273	230
Earnings before income taxes	3,348	2,811	2,329	1,607	1,585
Pre-tax profit margin	12.1%	11.1%	14.6%	11.6%	12.2%
Provision for income taxes	$ 1,506	1,333	1,074	718	681
Net earnings	1,842	1,478	1,255	889	904
Earnings per share	7.75	6.20	5.24	3.62	3.58
Dividends declared per share	3.15	2.475	2.00	1.70	1.45
Weighted average shares	238	239	240	245	252
Capital expenditures	$ 718	678	347	298	566
Annual depreciation	584	514	367	341	294
Property, plant and equipment (net)	6,582	6,237	5,684	4,014	4,381
Inventories	4,154	3,836	3,827	2,653	2,599
Working capital	1,396	1,432	1,926	1,289	1,117
Total assets	19,145	17,642	17,429	9,339	9,667
Long-term debt	5,222	5,945	7,331	2,059	2,515
Total debt	6,378	6,912	8,009	2,588	3,075
Deferred income taxes	1,288	994	872	784	737
Stockholders' equity	6,823	5,655	4,737	4,093	4,034
Funds from operations	2,789	2,214	1,775	1,547	1,349
Net earnings reinvested	1,093	888	776	472	538
Common dividends declared as % of net earnings	40.8%	39.9%	38.1%	46.8%	40.5%
Book value per common share	$ 28.83	23.77	19.85	16.86	16.14
Market price of common share high-low	124½–72¾	78–43⅞	47⅝–36	41⅝–31	36⅛–27
Closing price year-end	85¾	71⅞	44⅛	40⅜	35⅞
Price/earnings ratio year-end	11	11	8	11	10
Number of common shares—outstanding at year-end	237	238	239	243	250
Number of employees	113,000	111,000	114,000	68,000	68,000

Income from operating companies is income before corporate expense and interest and other debt expense, net.

Certain amounts appearing in the prior years' consolidated statements of earnings have been reclassified to conform with the current year's presentation.

General Foods Corporation was acquired in November 1985. Accordingly, consolidated operating results shown above include the operating results of General Foods Corporation after October 1985.

In 1984, a write-down of the completed but inactive Miller Brewing Company facility in Trenton, Ohio, reduced earnings before income taxes, net earnings and earnings per share by $280 million, $146 million and $.59, respectively.

2025865292

1982	1981	1980	1979	1978	1977	1976	1975	1974	1973
11.586	10.722	9.650	8.149	6.633	5.202	4.294	3.642	3.011	2.602
978	834	702	521	424	316	211	158	132	108
5.315	5.024	4.447	3.656	3.072	2.402	1.967	1.657	1.290	1.061
1.180	1.169	1.105	1.037	961	862	778	686	620	559
1.435	1.411	1.389	1.122	703	490	381	392	349	335
1.659	1.403	1.216	1.156	936	761	608	487	402	323
246	232	205	190	137	95	97	95	79	47
1.300	1.068	924	895	746	626	472	361	298	256
11.2%	10.0%	9.6%	11.0%	11.2%	12.0%	11.0%	9.9%	9.9%	9.8%
518	408	375	387	337	291	206	149	122	107
782	660	549	508	409	335	266	212	176	149
3.11	2.64	2.20	2.04	1.69	1.40	1.12	0.91	0.79	0.68
1.20	1.00	.80	.625	.513	.391	.288	.231	.194	.169
251	250	249	249	241	239	238	234	223	219
918	1.019	751	629	566	280	220	245	216	175
250	211	178	133	106	79	65	50	38	30
4.178	3.583	2.806	2.214	1.738	1.202	994	851	660	510
2.834	2.922	2.499	2.235	2.189	1.818	1.658	1.448	1.269	1.009
1.989	1.798	1.662	1.728	1.585	1.416	1.202	891	725	515
9.622	9.115	7.302	6.322	5.608	4.048	3.582	3.134	2.653	2.108
3.746	3.498	2.597	2.447	2.147	1.427	1.248	918	768	500
3.746	3.804	2.800	2.507	2.372	1.564	1.526	1.443	1.239	947
565	411	303	220	150	104	78	71	67	47
3.663	-3.234	2.837	2.471	2.115	1.690	1.430	1.228	975	815
1.160	976	784	703	577	444	348	261	211	178
480	408	350	352	284	254	197	157	132	111
38.6%	37.9%	36.3%	30.6%	30.6%	27.9%	25.7%	25.7%	24.8%	25.0%
14.55	12.89	11.37	9.92	8.51	7.05	6.01	5.17	4.26	3.68
33⅞–22	27½–21	24¼–14½	19⅜–15⅝	19⅛–14	16¼–12⅞	15⅞–12½	14¾–10¼	15⅜–8½	17⅛–12¼
30	24⅜	21⅝	18	17⅝	15½	15½	13¼	12	14⅛
9	9	9	8	10	11	13	14	15	21
252	251	250	249	249	240	238	237	229	222
72.000	72.000	72.000	65.000	60.000	53.000	51.000	48.000	38.000	37.000

2025865293